

# Project Notes

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## **Introducing an Improved Financial Accounting System in Urban Local Bodies in India: *The Successful State-wide Reform Initiative in Tamil Nadu***

*As cities in India begin to develop projects that reflect principles of commercial viability and explore private sector participation, the importance of reliable information on municipal finances has come to the fore. The municipal accounting system is the source of this information, and there is a serious need for reform of the current system. The State of Tamil Nadu has taken the lead in introducing a double entry accrual based system state-wide with technical assistance from the FIRE project. This experience offers valuable lessons for other states and local bodies and is complemented by efforts of the Institute of Chartered Accountants of India. This Project Note describes the efforts of Tamil Nadu and an approach to adopting similar reform in other states.*

**I**n January 1999, the State of Tamil Nadu approved a measure to begin pilot testing of a double entry accrual based accounting system in two municipal corporations and 10 municipalities. With the pilot project successfully in progress, the state inaugurated this new system in its remaining three municipal corporations and 92 municipalities on April 1, 2000. Tamil Nadu is the first state in India to initiate such extensive accounting reforms on a state-wide scale.

Such extensive reform at the local level is challenging, especially since the accounting system affects all departments of an urban local body (ULB). But ULBs have become increasingly aware that if efforts to develop commercially viable infrastructure and to explore private sector participation are to succeed, this reform is essential.

### **The Need for Double Entry Accrual Based Accounting**

Since 1994, the FIRE project has been working with Indian cities to help develop urban environmental

infrastructure projects capable of attracting private sector investment. One of the chief stumbling blocks has been the inadequacy of information on municipal finances. The present accounting system does not provide enough information for analysts to assess the financial performance and position of a ULB. A financial statement is only as reliable as the system that produces it, and the single entry cash based system in use by most ULBs today is subject to a number of defects. In a single entry system, the accuracy of books cannot be verified. The absence of asset accounts limits control of fraud and misappropriation of assets and profit and loss statements and balance sheets cannot be prepared. A double entry accrual based system enables the preparation of reliable, detailed financial statements subject to checks and balances. These statements provide adequate financial information for decision-making.

### **Constraints to the Introduction of a New Accounting System**

Several key constraints must be overcome to implement the new system. First, *municipal staff*

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*currently lack the competency* required to introduce the new accounting system. Accounting personnel are typically clerks who are frequently transferred among departments, preventing them from specializing in accounting. Introducing the new system will require training not only for accounting staff, but also for those in other departments. Second, changes in accounting and financial reporting requirements require *legislative changes* at the state and/or city level. Third, an opening balance sheet must be prepared to implement the new system. This requires the collection of *information on fixed assets*, including their location, service levels and value, and determination of liabilities as of the date the fiscal year begins.

A final constraint is the *fear of penalty*. The present accounting system does not allow the financial health or net worth of a municipality or municipal corporation to be assessed. Nor do current financial reports explain significant accounting policies. As a result, they allow a municipal body to hide its inefficiencies. The new system would not allow this. Some administrators fear that they may be penalized based on the possible negative net worth position that would be revealed for the first time in the new financial statements. In fact, financial position reflects the accumulated performances of current and previous administrations.

#### **USAID-FIRE Project Approach to Improving Municipal Accounting Systems in India**

Realizing these challenges, the FIRE project approached the introduction of the new accounting system on three levels. On the national level, FIRE staff worked with the Institute of Chartered Accountants of India (ICAI) to develop a technical guide on accounts and a new financial reporting system for urban local bodies in India. At the same time, the FIRE project was assisting the Government of Tamil Nadu to develop a model system at the state level. Then it helped the Tamil Nadu Urban Development Project (TNUDP) to implement the new accounting system at the city level.

Reforming urban accounting and financial reporting systems throughout India is a continuous process with different institutions playing key roles.

- The ICAI finalized a *Technical Guide on Accounts and Financial Reporting System for ULBs in India* in September 2000. The guide is designed to assist states introduce a new accounting system based on generally accepted accounting principles.
- Central and state ministries that coordinate matters related to local government should employ ICAI guidelines in making relevant legislative changes, developing accounting

systems and manuals adapted to municipal needs and circumstances, and providing necessary support for implementation, especially by employing accountants.

- Municipalities and municipal corporations must assume responsibility for implementation and should encourage staff to specialize in accounting.
- Consultants may be tapped to help municipal staff set up double entry accrual accounting systems.
- Training institutions should develop training modules specifically for municipal staff. They could provide on-the-job training in addition to classroom training.
- Financial institutions should support the development and implementation of the improved accounting systems. They could provide incentives such as rebates or lower interest rates to reward ULBs for the new financial reporting formats.
- International development agencies must continue to support the efforts of the ICAI, Ministry of Urban Development, states, municipal bodies, and training and financial institutions to carry out accounting system reforms.

#### **Tamil Nadu - A Case Study on Introducing Accounting Reforms**

The State of Tamil Nadu decided to change to a double entry accrual accounting system in late 1997 because it wanted to be able to present acceptable information to funding agencies on the financial position and performance of ULBs. The state government began the process by appointing a committee chaired by a retired joint director of the Local Fund Audit in January 1998. State officials asked the FIRE project to help the committee develop a manual and implement the new accounting and financial reporting system throughout the state. At the time, there were no guidelines on how to do this in India.

The committee submitted its first draft of an accounting system manual for all ULBs in the state in June 1998. This draft was discussed in detail with the Commissioner of Municipal Administration, the Director of Local Fund Audit, and the Chief Executive Officer of the Tamil Nadu Urban Infrastructure and Finance and Services, Ltd. The Finance Department of the state also reviewed the draft.

The first part of the *Accounting Manual for Urban Local Bodies in Tamil Nadu* deals with accounting procedures,

the second part provides the chart of accounts, and the third part presents the new forms and formats to be used in the new accounting system. Every procedure, account and form was specifically designed for the state's ULBs. The committee developed separate procedures for key municipal functions, including taxes and fees accounting, water supply and drainage fund accounting, suppliers/material accounting, contractors accounting, loans and grants accounting, etc.

In January 1999, the state Department of Municipal Administration and Water Supply decided to test the new system in 12 selected cities. The pilot began at the start of the new fiscal year on April 1, 1999.

Meanwhile, the state Secretary referred the Tamil Nadu manual to USAID and the FIRE project for their review and referral to the recently-formed ICAI committee developing accounting standards for ULBs in India. The FIRE project and the Housing and Urban Development Corporation (HUDCO) organized a roundtable to discuss issues raised by the ICAI committee. Senior officials of the Tamil Nadu government, consultants writing the manual, ICAI committee members, and FIRE project and USAID staff met in September 1999 and reached unanimous decisions on several key issues. The issue of applicability of existing Indian accounting standards for municipal assets and revenue was raised. As a result, a chapter on "Norms of Recognition of Municipal Assets and Revenue" was inserted in the Tamil Nadu manual. The ICAI committee reviewed these norms but has not yet reached consensus on guidelines for valuing certain infrastructure fixed assets of municipal bodies, such as roads, parks, and municipal lands.

The municipalities in the pilot showed initiative in introducing the new accounting system. They set up the new accounts and maintained them on a double entry basis manually. They collected information on assets and liabilities using the forms in the manual and, with the help of consultants, produced opening balance sheets. Based on this success, in January 2000 the state Department of Municipal Administration and Water Supply instructed that the new accounting system be started in the remaining municipalities on April 1, 2000. Tamil Nadu thus became the first state to introduce comprehensive accounting reforms state-wide.

In order to ensure a smooth changeover to the new system, the state aggregated the 107 ULBs into 25 groups based on location and size. TNUDP-II, funded by the World Bank to oversee implementation of the new accounting system, contracted with 25 chartered accountant firms to assist ULBs introduce the new accounting manual. In March 2000, TNUDP-II, with technical and financial support from the FIRE project,

conducted a three-day program to train staff of each municipality and a one-day orientation to familiarize the accounting firms with the functioning of ULBs and the proposed municipal accounting system. A qualified chartered accountant and an accountant will visit each ULB and assist in implementation of the new accounting system for 18 months. The firms are providing on-the-job training, trouble-shooting, and helping to prepare financial statements based on the new system.

Tamil Nadu's accounting reform is one of the best examples of the reforms underway in India's urban sector. The process of revision of the manual continues, in light of ICAI's recently prepared technical guide and the state's ongoing review of the system. TNUDP-II is monitoring progress through two committees: one at the regional, field level and another at the state level. The state contracted with a firm to develop accounting software for the ULBs that will be introduced after it has been tested with cities using the new system manually. The state's goal is that all its ULBs prepare year-end financial statements on an accrual basis for the fiscal year ending March 31, 2001.

The Tamil Nadu example shows that accounting reforms can be successfully introduced state-wide where there is effective political and administrative leadership, the willingness of local officials to take bold initiatives, and continuous support by the state government and donor agencies, such as the World Bank and the USAID FIRE project.

### **Key Steps to Introducing an Improved Financial Accounting System**

The process of introducing accounting reforms will vary by state. There are certain lessons, however, that one can take from the Tamil Nadu experience. The FIRE project staff summarizes the key steps as follows:

- Assess the present accounting system, including the current methods of recording revenues and expenses;
- Structure the new municipal accounting system in accord with ICAI's technical guide on accounting and financial reporting for urban local bodies in India;
- Collect information on municipal properties, including dimensions, usage and value, in order to prepare an opening balance sheet;
- Propose appropriate legislation required to change the municipal accounting system;
- Undertake the following tasks (often these can be done by consultants):

- Prepare a manual detailing the new accounting system and procedures, chart of accounts and forms/formats;
  - Develop norms for recognition of assets and revenue in accord with ICAI's national accounting standards;
  - Conduct both classroom and on-the-job training of municipal staff; and
  - Provide professional support to the municipal staff for at least the first 18 months of implementation of the new accounting system;
- Computerize the accounting system to increase capacity of local staff to maintain the new system;
  - Implement the new system together with the old one for at least eighteen months to allow time for phased transition to the new system and for officials to gain confidence and experience in operating it.

### Conclusion

Transparent financial information and standardized accounting practices not only enable effective governance, but also form the foundation for carrying out municipal credit ratings, development of commercially viable urban infrastructure projects, and involvement of the private sector in the delivery of urban services. Most urban officials in India agree with the need to introduce a double entry accrual based accounting system. For the past five years, the USAID FIRE project has worked to establish an institutional basis for this reform. Now, with the issuance of ICAI's technical guide and the State of Tamil Nadu's revised accounting manual and experience introducing it in all its municipalities and municipal corporations, it will be much easier for other states in India to introduce improved accounting and financial reporting systems.

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This *Project Note* was written by G. P. Singh, Financial Management and Accounting Specialist of the FIRE project. The *Accounting Manual for Urban Local Bodies in Tamil Nadu* is available from the TNUDP office in Chennai, Tamil Nadu. The *ICAI Technical Guide on Accounts and Financial Reporting System for ULBs in India* is available from the ICAI office in New Delhi.

## Indo-US Financial Institutions Reform and Expansion Project - Debt Market Component FIRE(D)

The mission of the Indo-US FIRE(D) project is to institutionalize the delivery of commercially viable urban environmental infrastructure and services at the local, state and national levels. Since 1994, the project has been working to support the development of demonstration projects and of a sustainable urban infrastructure finance system. Now, the project is also pursuing this mission through:

- Expansion of the roles of the private sector, NGOs and CBOs in the development, delivery, operation and maintenance of urban environmental infrastructure;
- Increased efficiency in the operation and maintenance of existing water supply and sewerage systems;
- Strengthened financial management systems at the local level;
- Development of legal and regulatory frameworks at the state level;
- Continued implementation of the 74th Constitutional Amendment; and
- Capacity-building through the development of an Urban Management Training Network.

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